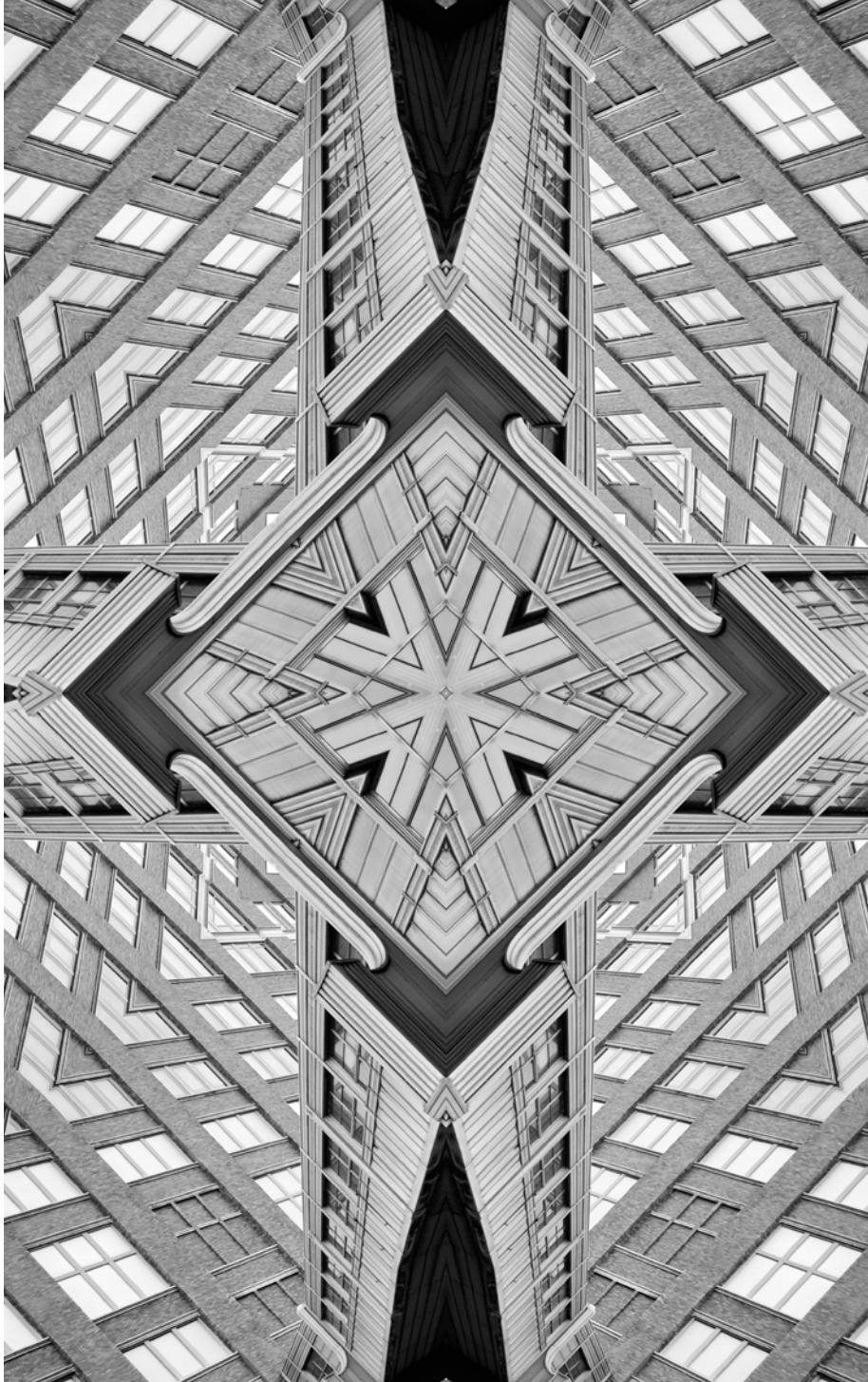


# Issue Brief

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# Pandemic Reopens Contentious Issues in Nepal-India Ties

Paras Kharel

## Abstract

The COVID-19 pandemic has highlighted two features of the Nepal-India economic relationship: Nepal's ballooning trade deficit, and unrestricted cross-border movement of people of both countries. Attributing the trade deficit entirely to supply-side constraints is neither accurate nor conducive to the overall health of the relationship. This brief suggests ways towards more sustainable trade relations between India and Nepal, among them, India relaxing the non-tariff measures it imposes on Nepali goods, Nepal improving its quality testing infrastructure, and a revision to the bilateral trade treaty. The brief points to the economic and security hazards of a porous border and argues that regulating it will be in both countries' long-term interest. It highlights the need for a resolution to the territorial disputes between the two, and strict non-interference by both in each other's internal affairs.

# Introduction

**A**s COVID-19 spread rapidly across the world, in South Asia, Nepal-India ties took a turn for the worse when India inaugurated in May 2020 a road it had built through Kalapani in west Nepal despite the latter's objections. The event touched a raw nerve in the Himalayan nation, where the presence of Indian troops in its far-west region and other cases of India's alleged border encroachment<sup>1</sup> have been a source of massive resentment. It brought back memories of India's 2015-16 blockade of the Nepal-India border, imposed right after a devastating earthquake in Nepal. This prompted a leading Nepali-language broadsheet to carry a headline drawing a parallel between the two episodes.<sup>2</sup>

On the economic front, the pandemic brought into sharp focus two key and contentious aspects of the bilateral relationship: Nepal's widening trade deficit with India, and a porous border. These issues have attracted renewed attention with the escalation of territorial disputes. The sight of Nepali agricultural produce rotting in the fields while imports continued unabated brought the trade deficit issue to the forefront.

Concerns about the adverse effects of a porous border are not new: the unrestricted cross-border movement of people has had impacts on domestic industry, local livelihood opportunities, law and order, and national security. The pandemic has heightened the pressure on the Nepali government to create jobs, including for migrant workers who have returned or are expected to return home from overseas following job loss. Attention is naturally drawn to the prospect of securing employment for Nepali nationals in activities performed by foreigners through the regulation of the border. Insurgents and terrorists, in the past, have exploited the porous border, with the Nepali state at the receiving end.

The pandemic enabled Nepal to attempt something that it is unlikely to have been done otherwise: close the border to the movement of people except for those returning home. While there are challenges in regulating the border in this manner, and enforcement is far from absolute, the pandemic-induced border controls have demonstrated that cross-border cargo movement can happen even without unfettered movement of people. The resulting decline in smuggling has brought cheer to industrialists and tax officials alike.

“Concerns about the adverse effects of a porous India-Nepal border are not new.”

# Trade Deficit

**I**ndia is a source of, and a destination for, nearly two-thirds of Nepal's merchandise imports and exports. Landlocked Nepal, so far, has relied exclusively on India for transit purposes: nearly two-thirds of Nepal's imports from countries other than India transit through India, the rest being air-freighted goods or overland Chinese imports.<sup>3</sup> Of the US\$8.7 billion in officially recorded bilateral goods trade with India in 2018/19,<sup>a</sup> 93.6 percent were imports by Nepal, resulting in a deficit of US\$7.6 billion.<sup>4</sup> The deficit accounted for nearly two-thirds of Nepal's total deficit in goods trade. This deficit has been rising both in absolute terms and as a percentage of total bilateral trade. Set against the standard gravity-model of trade, it can be seen that Nepal over-imports from, and under-exports to, India.<sup>5</sup> The import-to-export ratio rose from 2.3 in 2004/05,<sup>6</sup> on the eve of the sweeping political changes of 2006, to 14.6 in 2018/19.

Seen as a macroeconomic identity—with its current account balance a reflection of the difference between savings and investment—Nepal's overall trade deficit, of which the deficit with India is the predominant part, would be a manifestation of investment exceeding savings. However, this macroeconomic identity is not a statement about causality. In an economy where factors of production are highly underutilised, it is possible to increase exports with the existing level of savings. Importantly, removal of trade barriers in destination markets could increase exports, given the level of savings. And when exports increase, output/income increases too, which, in turn, could yield higher savings. In any case, a more careful and comprehensive look at trade imbalances than allowed by a mechanical approach is, increasingly, no longer taboo in the post-pandemic milieu.

While there are factors within Nepal that impede the realisation of its export potential,<sup>7</sup> attributing the trade deficit to supply-side constraints alone is neither empirically accurate nor conducive to the overall health of the bilateral relationship. The surge in trade imbalance can be partly traced to the 2002 revision of the liberal 1996 trade treaty between the two countries. The revision introduced restrictive provisions, notably onerous rules of origin, as well as

“For Nepal, the surge in its trade imbalance with India can be partly traced to the 2002 revision of the 1996 trade treaty between the two.”

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<sup>a</sup> Nepal's fiscal year runs from mid-July of one calendar year to mid-July of the next year.

# Trade Deficit

quantitative restrictions, on the then key export items of Nepal.<sup>8</sup> In periodic meetings on bilateral trade, Nepal continues to demand the removal of quantitative restrictions on vegetable ghee, acrylic yarn, copper products and zinc oxide imposed 18 years ago. Para-tariffs on Nepali exports also increased following the 2002 revision.<sup>9</sup> (With the introduction of the goods and services tax (GST) in India in 2017, however, the imposition of border taxes other than customs tariffs has become more transparent, and para-tariffs have been mostly removed.)<sup>10</sup>

If, on the one hand, Nepali farmers are unable to compete with subsidised agricultural imports, Nepal's exports—both agricultural and manufacturing—face an array of non-tariff measures (NTMs) on the other that negate the customs duty-free market access offered by India.<sup>11</sup> Reports of indigenous farmers' produce rotting in the fields even as imports found a ready market during the pandemic-induced lockdown made the headlines in Nepal,<sup>12</sup> directing renewed public attention to the trade deficit issue. In 2018/19, Nepal imported four times more agriculture products, in value terms, from India than it exported to India. The existing trade treaty needs a revision to exempt Nepal from having to provide tariff-free market access to primary agricultural products from India,<sup>13</sup> or at least to allow Nepal to place select products on a sensitive list that is shielded from zero-tariff requirements. While this would mean Nepal not reciprocating India's provision of duty-free market access to primary agricultural products, it would be consistent with the principles of 'less-than-full-reciprocity', and special and differential treatment, in deference to differing levels of development and structural constraints across countries, that both Nepal and India advocate at the World Trade Organization (WTO). It would also be in sync with India's resolute position on food security and rural livelihoods at the WTO. In any case, India extends the same tariff concessions that it provides Nepal under the bilateral treaty to all other least developed countries in South Asia<sup>b</sup> under the Agreement on South Asian Free Trade Area, but without the recipients having to offer duty-free access to primary agricultural products to India in return. A provision in the treaty that constrains Nepal's ability to sign preferential trade agreements with third countries needs to be removed as well.<sup>14</sup>

The relative importance of NTMs—sanitary and phytosanitary measures and technical barriers to trade—has increased with India reducing its tariffs in general (and for least developed countries in particular), resulting in preference erosion for Nepal. The technical regulations and conformity assessment requirements imposed by NTMs, and the associated procedural obstacles, pose stringent barriers to exports from Nepal, especially of agricultural products, in which Nepal arguably has a natural comparative advantage.<sup>15</sup> Arbitrary

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<sup>b</sup> These are Afghanistan, Bangladesh and Bhutan.

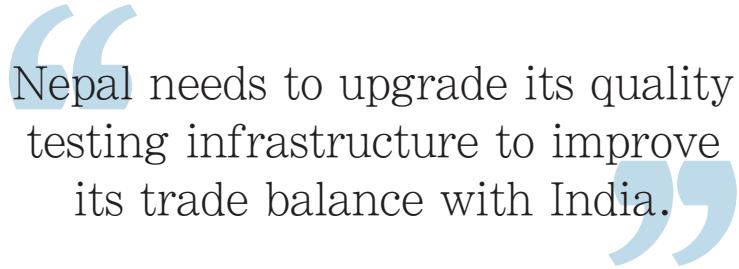
# Trade Deficit

decisions of officials at the border are also barriers for Nepali exporters.<sup>16</sup> The unpredictability in the application of rules, including those related to NTMs, has created uncertainty. The adverse effects of trade policy uncertainty have been rigorously documented in international trade literature.<sup>17</sup> There is anecdotal evidence of it discouraging, for instance, ginger farmers in Nepal who sell predominantly to the Indian market.<sup>18</sup>

Nepal, for its part, needs to upgrade its national quality testing infrastructure<sup>19</sup>—comprising standardisation, testing, measurement, certification and accreditation. This will not only help its exports but also equip it to stem imports of substandard products. It should also try to mitigate information asymmetries so as to enable the Nepali private sector to meet India's requirements in a cost-effective manner.<sup>20</sup> These should be complemented, on India's part, by relaxing onerous conformity assessment requirements, removing procedural obstacles, reining in arbitrariness in decision-making and ensuring a predictable trading environment. A promising start would be proper implementation of the agreement reached in August 2019 whereby the Food Safety and Standards Authority of India (FSSAI) recognises the National Food and Feed Reference Laboratory of Nepal's Department of Food Technology and Quality Control (DFTQC) and accepts tests analysis certificates issued by DFTQC for 24 food and agriculture products.<sup>21</sup> This could pave the way for a more comprehensive mutual recognition agreement in future.

However, the agreement also requires the DFTQC to obtain accreditation from India's National Accreditation Board for Testing and Calibration Laboratories (NABL) on all parameters as per India's Food Safety and Standards Regulations, 2011. Nepal has been asking India for support in developing standards and improving its quarantine and testing capabilities.<sup>22</sup> This is in line with a provision introduced in the trade treaty in 2009, by which India has pledged to assist Nepal to "increase its capacity to trade through improvement in technical standards, quarantine and testing facilities, and related human resource capacities."<sup>23</sup>

An effective bilateral mechanism is essential at the local and central level. The 2009 revision to the trade treaty had provided for a joint mechanism, comprising local authorities, to resolve problems arising in the clearance of goods at customs points. Effectively operationalising this mechanism could reduce the barriers and hassles at the border. At the central level, joint secretary- and secretary-

Nepal needs to upgrade its quality testing infrastructure to improve its trade balance with India.

# Trade Deficit

level talks have not been held with the regularity stipulated in the treaty. Good faith is also required at the highest political level for the treaty to be effective. An example of the importance of constructive initiatives coming from the top political leadership was the negotiation of the "liberal" 1996 trade treaty, seen by some as the Gujral doctrine<sup>c</sup> in action.<sup>24</sup>

Formal policies and rules are not everything. After all, the blockades of 1989-90 and 2015-16 happened despite the trade and transit treaties. Or, as India's external affairs ministry intimated in January 2020, in connection with its curbs on palm oil imports from Malaysia, "for any commercial trading, the status of relationship between any two countries" is something a business would consider, after stating that the curbs were not country specific.<sup>25</sup> As a nation with a political class,<sup>26</sup> not to mention economists,<sup>27</sup> concerned about its own trade deficit with China, India ought to appreciate the trade concerns of a small neighbour with which it avowedly has "unbreakable", "roti-beti" (family-like) ties.<sup>28</sup> And just as India's officialdom will not buy the argument that it is India's own weak productive and supply capacity that is the prime factor holding back Indian exports to China, so too it should not ascribe Nepal's trade deficit to the same reason.

“India should appreciate the trade concerns of its neighbour with which it avowedly has “family-like” ties.”

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c The 'Gujral doctrine', formulated in the mid-1990s by India's then prime minister Inder Kumar Gujral, was a five-point roadmap seeking to build trust between India and its immediate neighbours.

# Porous Border

**W**ork-related migration and remittance are a two-way street between Nepal and India.<sup>29</sup> The 1950 Treaty of Peace and Friendship per se does not require an open border, but its implementation has meant unfettered cross-border movement of the two countries' nationals, including for work.

A study using official survey data in Nepal estimated the number of Nepalis working in India, in 2017/18, at just under one million.<sup>30</sup> There has been no credible survey, at least in the last three decades – official or non-official – on the presence of foreign workers in Nepal. Media reports have claimed that Indian workers in Nepal number about a million,<sup>31</sup> engaged in a variety of occupations, unskilled and skilled. The World Bank's bilateral migration and remittances matrix database<sup>32</sup> estimated in 2017 that Indians remitted home from Nepal thrice the amount Nepalis did from India: US\$3 billion versus US\$1 billion. Remittances from India make up about 15 percent of remittances sent home by Nepalis working abroad.<sup>33</sup>

Given the asymmetry in the population and economic size of the two countries, reciprocity in the movement of people for work and other purposes has long been held in Nepal as putting it at a disadvantage, having demographic implications as also affecting Nepali citizens' livelihood options on Nepali soil. The porous border also has security implications, a case in point being the 1996-2006 Maoist insurgency in Nepal that exploited the unregulated border to the hilt.<sup>34</sup> Allegations of the border being abused to harm India are reported in the Indian media too.

The World Bank forecasts Nepal's economic growth for 2020/21 at 0.6 percent.<sup>35</sup> The challenge of providing jobs to those rendered unemployed by the pandemic, including Nepali migrants returning from India and other countries, has opened the possibility of substituting foreign labour with domestic labour. At least 800,000 are expected to return due to job losses overseas,<sup>36</sup> putting further pressure on the domestic labour market already reeling under the pandemic's adverse effects<sup>37</sup> and unable to provide decent-wage jobs to the vast majority of labour even before COVID-19.<sup>38</sup> In announcing its budget for 2020/21, the Government of Nepal pledged to help citizens fill jobs vacated by foreign workers who left the country or could not return due to the pandemic. This is the first time in at least 30 years that a crucial policy document has broached the idea of substituting foreign workers with Nepali citizens.

“ To provide jobs to those left unemployed by the pandemic, Nepal faces the possibility of substituting foreign labour with domestic labour. ”

# Porous Border

It has been over nine months since the closure of the India-Nepal border to the movement of people except for those returning home, instituted in mid-March as part of the corona virus containment measures. Cargo movement has continued, showing that bilateral and transit trade can happen even without unrestricted movement of people. Never in the last 70 years has the border been closed in this manner for such a long period. Strictly controlling cross-border movement of people to check the pandemic is testing the state's capacity—which only shows the cost of decades of neglect of what is both an economic and security imperative. Unable to get decent jobs at home, there are reports of Nepalis returning to India for work in tens of thousands even as COVID-19 cases escalate in India.<sup>39</sup> Public reactions to such news reports have been marked by anger at the system's failure to provide returnees with decent livelihood options.

With the entry of foreign workers into the country impeded by the pandemic-induced enhanced border controls, the manufacturing sector is reportedly struggling under a shortage of labour. This has prompted the government to formally consider allowing in foreign workers,<sup>40</sup> indicating the difficult choice it faces in the short run. The pandemic has brought under unprecedented public scrutiny the massive failure on the employment front, even over a decade after the 2006 regime change—and even after the introduction in 2015 of federalism, billed as a path to prosperity. The number of Nepali male wage workers in Nepal is roughly equal to the number of Nepali males earning wages on foreign shores.<sup>41</sup>

The Government of Nepal has to roll out a credible plan for job creation, which includes substituting foreign workers with Nepali citizens to the extent possible, in the medium to long term. Provision of information, identification of skill gaps, and skilling are key to this. If it is acceptable, up to a point, to protect domestic industry—and, by extension, jobs—with tariffs, it is only logical to directly shield citizens from competition from foreign workers. Otherwise, discontent over lack of jobs could spiral out of control. An underground party (the Biplov-led Communist Party of Nepal, which broke away from the Maoist party) sees continued relevance of the unfulfilled demands among the 40-point charter of demands that was the original basis of Nepal's Maoist movement. (The Maoist top leadership, which is now part of the political mainstream, was based for the better part of its decade-long insurgency on Indian soil.)<sup>42</sup> These demands include abrogation of the 1950 Treaty and an end to the recruitment of Nepalis in the Indian army.

Controlling cross-border movement of people to check the pandemic is testing the Nepali state's capacity.

# Porous Border

There are reports of a marked decline in smuggling into Nepal owing to the border being regulated in the wake of the pandemic.<sup>43</sup> A leading industrialist, who also heads a nationwide private-business umbrella group, has said that the border should be fenced to rein in smuggling and create jobs.<sup>44</sup> Similarly, the government's finance secretary has said that the closure of the border has had a positive impact on the economy, spurring domestic production and contributing to tax revenue.<sup>45</sup>

As the pandemic unfolds, orderly and safe cross-border movement of Nepali and Indian citizens returning home should be a priority. In the medium to long term, regulation of the porous border by subjecting those crossing the border to ID checks and allowing such movement only at designated points, along with an arrangement that allows Nepal to protect its labour market from foreign competition, would make for reduced frictions.<sup>46</sup> As a first step, India should accept the report drafted in 2018 by the Eminent Persons' Group that the two countries had formed to review bilateral treaties. Border regulation has only to build on the pandemic-induced tightened border controls, which have demonstrated that such regulation does not impede trade and transit of formal goods. Indeed, uninterrupted cargo movement through the Nepal-India border contrasts with the virtual closure of the Nepal-China border to the movement of trucks amid the pandemic, even as some 1,000 Nepal-bound containers, containing goods from apples to readymade garments, have remained stranded on the Chinese side of the border for as long as 10 months.<sup>47</sup>

As the pandemic enters year two, the orderly cross-border movement of Nepali and Indian citizens returning home should be a priority.

# Broader Canvas

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**A**ddressing Nepal's concerns about trade deficit and unfettered cross-border movement of people will go some way towards putting bilateral relations with India on a smoother footing. For sustained warm ties, however, a clear shift in attitude is needed. India should view Nepal's assertion of its territorial integrity in relation to the Kalapani-Lipulekh-Limpiyadhura area (where it built a road despite Nepal's opposition) as a spontaneous, organic expression rather than as Nepal being provoked by an external hand. India is not only shying away from talks with Nepal on the matter, but its media is frenetically getting its public worked up over China's alleged encroachment on Nepali territory in multiple places. To do so, it has been citing a fake document attributed to a non-existent 'survey department' under Nepal's Ministry of Agriculture. (Nepal does have a survey department, but it is not under the Ministry of Agriculture.)<sup>48</sup>

Some Indian analysts<sup>49</sup> have had a field day using this fake news item as grist to their China-bashing mill, lamenting that India is losing Nepal to China. While it is not known if China has indeed encroached on Nepal's northern territory, sections of the Indian media and intelligentsia are constructing such a narrative.

A vista of fresh and crisp Nepal-India ties based on an even keel can open only if India's intelligentsia and political class take to heart a synthesis of three mutually complementary views disparately circulating in their own midst: that India should stop viewing Nepal as a backyard where its writ runs large, that the 2015-16 blockade was a disastrous mistake, and that the 2006 regime-change adventure has come a cropper.<sup>50</sup> Such a realisation would also provide a basis for mutually beneficial economic interactions. Fostering cordial relations with a neighbour, which has never hurt core Indian interests, should not be a difficult enterprise for a nation with global power ambitions. ORF

“ India and Nepal should immediately resolve their issues of trade deficit and unfettered cross-border movement of people. ”

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